COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department of Public Utilities upon its own motion commencing a Notice of Inquiry/Rulemaking, pursuant to 220 C.M.R. §§ 2.00 et seq., establishing the procedures to be followed in electric industry restructuring by electric companies subject to G.L. c. 164.	)	D.P.U. 96-100

COMMENTS OF MASSACHUSETTS ELECTRIC COMPANY

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Massachusetts Electric Company ("Mass. Electric") presents these comments on the industry restructuring plans that have been filed by other parties. Our comments are structured in a format that is designed to assist the Department as it drafts proposed rules and recommendations for issuance on May 1, 1996. As we describe more fully below, most of the issues identified by the Department as within the scope of the rulemaking proceeding fall into one of three categories. The first group consists of issues on which the plans differ, that are ripe for decision, that require a uniform statewide implementation approach, and that the Department needs to address in order to bring the debate down from the 50,000 foot level to the 5000 foot level. These issues include: 1) the start date for retail customer choice; 2) the market structure; 3) the means for providing default or transition service during the transition period; and 4) the ground rules for functional unbundling in a way that would preclude the exercise of vertical market power.

The second category of issues involves those on which there appears to be general agreement in concept among the filed plans and on which there should be a uniform approach to implementation across utilities. These issues include distribution, demand-side management, universal service and the tax impacts of restructuring.

The third category consists of issues that the Department should not attempt to resolve on a generic basis now. This group has two subcategories. The first is comprised of those issues

that require a recognition of the different facts and circumstances facing different utilities. A generic rule or recommendation on these issues would stifle creative proposals in the context of individual company adjudications and would thus diminish the prospects for attaining optimal restructuring plans. These issues include the calculation of stranded costs, including the determination of residual value, and reductions in air emissions. The second subcategory consists of issues that the Department simply does not have to address in order to implement customer choice by January 1, 1998 for investor-owned utilities. The issues in this subcategory include horizontal market power, transmission and performance-based ratemaking. Proposing rules or recommendations to resolve these issues would serve no useful purpose and could complicate and slow the industry restructuring process.

Prior to addressing the three categories of issues, however, Mass. Electric comments on the Department's plan to issue proposed rules on May 1. The Department should at this point confine its proposed rules to the issues over which it has jurisdiction. The Department has recognized that the extent of its jurisdiction is limited over many of the critical issues associated with restructuring, and the development of proposed rules on issues over which it has limited jurisdiction would serve no useful purpose. As Mass. Electric explained in its February 16 *Choice: New England* filing, the Department does not have the legal authority to force the divestitures, unlimited access to transmission and distribution systems, New England Power Pool ("NEPOOL") reforms, or contract terminations with power suppliers and retail customers that are contemplated in the various restructuring plans. *Choice: New England Legal Commentary* at 7-11. Thus, even if the Department were to propose rules to address some of these issues, those rules would largely be ineffective in attaining their purpose. Rather, consensual restructuring agreements must be developed to address and resolve the issues that extend beyond the Department's statutory authority.

The Department should, however, use this generic proceeding to make clear findings on the issues where further guidance by the Department would promote restructuring, those issues

discussed in Section I below that are ready for and require resolution, and those issues discussed in Section II below on which there appears to be agreement. The Department should refrain from making findings on the issues where generic pronouncements would not facilitate consensus, such as those discussed in Section III below that are not ready for resolution.

I. Issues Ready For and Requiring Resolution.

The restructuring plans pending before the Department differ on four issues that are ripe for resolution and that require a uniform statewide implementation approach. The choice that the Department makes on each of these issues will affect whether customer choice can practicably be implemented by 1998. On three of these issues, the Division of Energy Resources ("DOER") advocates a position that would, if adopted by the Department, almost certainly delay the implementation of customer choice. Thus, it is important for the Department to make findings soon to establish both the direction that industry restructuring should take and the timing for implementation.

A. Start January 1, 1998. The Department should make a clear finding that all electric companies should implement retail choice on January 1, 1998.

B. Market Structure. The Department should clearly find that significant market structure changes are not necessary to implement customer choice in Massachusetts. Consistent with *Choice: New England*, restructuring can and should proceed regardless of whether significant changes are made to NEPOOL.

The issue affects both the timing of restructuring and the development of a mechanism for providing default service. DOER advocates a market infrastructure change that involves the creation of two new entities separate from NEPOOL. The first, called an independent system operator, would operate the interstate transmission grid, and the second, called a power exchange, would determine how power is traded.

DOER's vision of the market structure is inconsistent with the next phase of NEPOOL reform that has been unanimously approved by NEPOOL members across six states. As a result, it is highly unlikely that a consensus in favor of the DOER model can be developed in New England, and less likely still that such a consensus could be achieved in time to implement the DOER model by 1998.

DOER implies that absent a New England spot market, a Massachusetts-only spot market could be implemented. This proposal suffers with respect to both its feasibility and its timing. In order to create a Massachusetts only spot market, all of the complex issues that arise in the context of NEPOOL reform would still have to be resolved. In addition, new rules would have to be developed to govern the interrelationship between the Massachusetts market and the NEPOOL market.

Moreover, Massachusetts benefits from being in a larger region. Doing anything to balkanize the region would be a step backwards that would hurt customers. We cannot pretend that Massachusetts is an electrical island.

Finally, a critical element of restructuring is choice for all. This means choice without special meters. Mass. Electric has developed a method for implementing retail choice without special meters under the NEPOOL structure. The approach will be tested in Mass. Electric's pilot program. We do not know how to implement choice, provide ancillary services, and avoid special metering under the DOER model. Devising an approach that resolves these issues without the NEPOOL structure would almost certainly result in unacceptable delay.

Choice: New England can begin without major changes to the existing NEPOOL structure while using that structure to support a fair and efficient transition to customer choice. *Choice New England*, Sergel Testimony at 9-13. It is a practical approach that would allow customer choice to be introduced by January 1, 1998. The Department should find that the implementation of customer choice should proceed without requiring market structure changes.

C. Transition Service. The Department should endorse the standard offer in *Choice: New England* as the method for providing default or transition service statewide. This is essential in order to provide the orderly transition with minimum customer confusion called for by the Department's principles.

Transition service is service to those customers who do not choose a generation supplier at the start of retail competition. DOER proposes a "basic service" model for default service that would rely on a spot market that, as discussed above, will likely not be in place by 1998. For this reason alone, DOER's basic service model almost certainly would necessitate a delay in implementing customer choice. Furthermore, if and when a spot pool is established, the Department should not recommend it for default service until the pool is shown to work with demonstrated efficiency.

DOER's model is also insensitive to the needs and desires of customers who should be able to go to the market at their own pace and to know from whom they are buying power. DOER's proposal satisfies neither of these criteria. It would push all customers into the market at the outset of retail competition whether or not those customers want to enter the market. This is especially problematic given the uncertainty associated with the development of the market at the outset. Pushing every customer involuntarily into a new, untested service that would almost certainly be imperfect and require refinements would likely result in enormous costs and customer confusion.

In addition, customers would not know who their generation supplier is under the DOER's model. Marketing companies would be precluded from using a name associated with an existing electric company. This alone could be a source of customer concern and confusion.

The DOER basic service model would also expose customers involuntarily to greater price volatility. The experience of the British and Norwegians with spot market prices is instructive. Attachment A is a graph showing the volatility of average daily prices in the British spot pool. Examining average daily prices over four to five week periods shows the volatility of

the average monthly prices. From early 1995 to early 1996, monthly average prices varied from less than $40 per megawatthour ("/Mwh") to over $60/Mwh.

Attachment B shows average daily and monthly prices in the Norwegian spot market. In a recent three-year period, they varied from less than $10/Mwh to more than $30/Mwh. Thus, under the DOER proposal, customers who take no action at the outset of choice would likely experience much greater price volatility than they have come to expect.

In contrast to the DOER proposal, the standard offer in *Choice: New England* would provide all customers that do not choose a supplier at the outset with service similar to what they now receive. They would pay a stable price that would start at the regulated rate and increase no faster than inflation. Regulators would be able to reassure nervous customers not ready to enter the market by telling them in advance the most they will pay for electricity after choice day, as opposed to telling them that they will pay whatever the market price happens to be. Customers would decide for themselves when to enter the market, and would choose their generation supplier. *Choice: New England*, Sergel Testimony at 6-9. As a result, the standard offer in *Choice: New England* would provide an orderly, expeditious transition that would minimize customer confusion.

For all these reasons, the Department should find that the standard offer model in *Choice: New England* should be used to provide default service in the restructured industry.

D. Functional Unbundling. The Department should find that utilities should take three steps to guard against the exercise of vertical market power. First, utilities should file nondiscriminatory distribution access tariffs with regulators. Second, utilities should operationally separate their generation, transmission, distribution and marketing functions, and third, utilities should develop and implement standards of conduct that would preclude a distribution company from favoring a marketing affiliate over nonaffiliates.

DOER argues for a different approach that conflicts with the Department's restructuring principle favoring functional unbundling. DOER would "...require utilities to voluntarily divest those assets which are not needed to supply Transmission and Distribution Services...." Power Choice at 22. If DOER is advocating mandatory divestiture, its proposal is unlawful. The Department has correctly concluded that "...there is no explicit statutory authority by which the Department may order divestiture, nor is it likely to be implied." D.P.U. 95-30 at 41, n. 31. On the other hand, if the DOER is advocating that voluntary divestiture should be a prerequisite to the introduction of customer choice, then its proposal is a prescription for delay. The Department was correct in its order in D.P.U. 95-30 when it stated that "mandatory divestiture ... is not desirable or necessary at this time." D.P.U. 95-30 at 24. Nothing in DOER's proposal undercuts the Department's conclusion on this issue.

Choice: New England would implement functional unbundling through a series of actions. First, just as the Federal Energy Regulatory Commission ("FERC") has proposed that utilities file nondiscriminatory access tariffs for transmission service, utilities should also file nondiscriminatory access tariffs for distribution service as part of a restructuring that provides for the recovery of stranded costs.

Second, to assure that the tariffs are truly non-discriminatory in practice, utilities should operationally separate their generation, transmission, distribution and marketing functions. Separate affiliates with separate sets of books should be formed for each of these functions. This would create a visible system for guarding against cost shifting among functions that could readily be policed by both regulators and competitors.

Third, utilities should develop and implement standards of conduct to govern business dealings between the distribution company and its market affiliates. This is the model that the FERC has followed in the gas pipeline industry and, based upon NEP's own experience and conversations with other gas market participants and regulators, that model appears to be working well. FERC's standards of conduct preclude the monopoly function from giving a

preference to its affiliate over nonaffiliates, and require any information that the monopoly function provides to its affiliate to be provided contemporaneously to nonaffiliates. 18 C.F.R. §161.

Consistent with *Choice: New England*, the Commission should find that utilities should implement nondiscriminatory distribution tariffs, operational separation and standards of conduct to guard against the exercise of vertical market power. *Choice: New England* provides a pragmatic approach for implementing functional unbundling without delaying the start of customer choice.

II. Uncontested Issues.

A. Distribution. The Department should find that all utilities should file comparable, nondiscriminatory distribution tariffs with regulators as part of a restructuring that provides for the recovery of stranded costs as discussed in the previous section.

B. Demand-Side Management. The Department should recommend that demand-side management programs continue during the transition period, be funded through distribution rates, and be uniform statewide.

C. Universal Service. The Department should recommend that existing rate discounts for low-income customers continue and be funded through distribution rates. The discounts should be uniform throughout Massachusetts. In addition, the Department should approve Mass. Electric's proposal for safety net service after retail choice is implemented.

D. Tax Impacts of Restructuring. The value of most utility-owned generating plants would likely decrease as a result of restructuring and, therefore, the local property taxes paid on those plants would also decrease. Indeed, lower property taxes is one of the sources of the customer savings that restructuring would make possible. If utilities and communities negotiate

transition agreements that provide for payments to the communities in lieu of taxes during a transition period, however, then the payments in lieu of taxes should be considered an element of stranded costs.

III. Issues Not Ready for Resolution.

A. Any Attempt to Resolve Certain Issues on a Generic Basis Would Be Counterproductive. The Department should refrain from issuing rules or recommendations on two issues: the calculation of stranded costs, and reductions in air emissions. Each of these issues should ultimately be addressed in a way that recognizes the different facts and circumstances of each utility. A generic approach would be counterproductive. It would stifle creative proposals in the context of individual company adjudications and would thus diminish the prospects for attaining optimal restructuring plans. In addition, with respect to the calculation of stranded costs, any rule that when applied to an individual company would deny that company recovery of its stranded costs would inevitably trigger court challenges even before the adjudicatory proceedings commence.

1. Calculation of Stranded Costs. All of the plans that have been filed with the Department support allowing utilities the opportunity to recover the sunk costs that would be stranded as a result of retail competition. The differences among the parties concern the methodologies for calculating the amount of stranded costs.

The calculation of each utility's stranded costs requires a recognition of the different facts and circumstances facing each utility. For example, Eastern Edison Company proposes that a utility's sunk investment in nuclear generation should be included in the determination of stranded costs, but that sunk investment in fossil or hydro generation should be excluded. There is no sound logical or conceptual basis for providing investment in nuclear generation more favorable cost recovery treatment than investment in fossil or hydro generation. Nonetheless,

given Eastern Edison's position with little unrecovered investment in fossil or hydro generation, excluding such investment from the calculation of its stranded costs would apparently be acceptable to Eastern Edison. It would not be acceptable to Mass. Electric or most other utilities with more unrecovered fossil or hydro plant investment. Thus, what might work for Eastern Edison in light of its factual circumstances would not work as a generic rule.

Another example involves how one measures the residual value of a utility's generating assets. The plans that have been filed suggest a number of different methods for determining residual value. *Choice: New England* would credit customers with three different elements for the residual value of New England Power Company's ("NEP") generation: 1) a low equity return equal to a triple B bond rating plus one percent on the unamortized balance of NEP's generation investment and regulatory assets; 2) the proceeds from the sale of the generating plants; and 3) revenue losses. If, as expected, the up-front market prices are less than the operating costs of some of NEP's generating plants, then NEP would bear the losses associated with operating those plants.[1] On the other hand, if market prices are high, NEP would then bear revenue losses associated with the standard offer. NEP would, through a new affiliate, extend a standard offer to sell electricity to all customers in Mass. Electric's franchise territory at predetermined rates, and NEP would bear the revenue losses associated with the difference between the standard offer rate and market prices. *Choice: New England*, Sergel Testimony at 37-39.

DOER proposes a different approach. It suggests that residual value be determined through a market valuation. In California, the residual value of generation was one of the numbers that was negotiated.

There is no one right or best way to determine residual value. *Choice: New England* proposes one reasonable way, but Mass. Electric would also entertain reasonable market

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[1]NEP would of course operate generating plants at a loss for a time only if the plants remain profitable on a life-cycle basis. Otherwise, under *Choice: New England,* NEP would have the financial incentive to shut down such plants.

valuation approaches. Any attempt by the Department to decide now the method for determining residual value would, at a minimum, constrain the available options that will otherwise be considered during the adjudication of the individual company plans. At worst, a decision now could lock in a method for determining residual value that is flawed and thereby create obstacles to implementing customer choice by 1998.

An example of an approach for determining residual value that would likely result in a significant delay in implementing customer choice is DOER's sale by auction proposal. Given that the same assets can yield widely different amounts depending upon the rules of an auction, those rules would likely be vigorously contested. Moreover, once rules were established, the auction process itself would likely be a complex and time-consuming undertaking. The auction conducted by the Federal Communications Commission in 1994-95 for wireless personal communication system licenses is illustrative. The auction required bidders to devote significant parts of their staff for at least a year to understanding the assets to be auctioned and the auction structure. The auction itself took four months to complete with one to three rounds of bidding per day. Thus, if market-based methods are used to determine residual value, utilities should be allowed to use approaches other than the administratively controlled auction approach suggested by DOER.

The Department should facilitate industry restructuring, not create more obstacles. For this reason, it should not issue a generic rule or recommendation on the calculation of stranded costs. Rather, it should provide the flexibility for parties to develop creative approaches in the context of the adjudicatory proceedings on the individual company plans.

2. Environmental Regulation. The amount of air emission reductions that is appropriate for each utility should also take into account the different starting points among the utilities. *Choice: New England* is the only utility restructuring plan that includes a concrete proposal for reducing air emissions. It includes a series of cost-effective reductions in air

emissions that are designed to keep Massachusetts one step ahead of upwind states in reducing the environmental impacts of electric generation. *Choice: New England*, Tranen Testimony at 3-6. Nonetheless, the targets and timing of emission reductions included in *Choice: New England* may not be appropriate for other utilities that start with a different generation mix. The level of emissions reductions for each utility should therefore be decided in the context of each individual company's plan.

Deferring emission reductions to the individual company adjudications makes sense for another reason. The Department lacks the legal authority to impose emission reductions beyond the levels required by the environmental laws. Massachusetts Electric Co. v. DPU, 419 Mass. 239, 247 (1994). The amount of emission reductions for each utility must therefore be the product of consensual agreements.

The DOER emissions reduction proposal would result in higher costs for Massachusetts customers with little or no improvement in air quality. Costs would increase because DOER's proposal would result in either significant expenditures at existing fossil units or the shutdown of units to avoid those investments. In either case, consumers would lose the relatively low-cost power that they receive from those units today. Little or no improvement in air quality would result because, as Department of Environmental Protection Commissioner David Struhs has explained in a letter to FERC Chair Elizabeth Moler, electricity generation in Massachusetts is already generally cleaner than generation in upwind states. Governor Weld and Commissioner Struhs have both recently written to officials in Washington explaining that the quality of air here is linked to emissions from generators in upwind states. Massachusetts will not attain compliance with the federal ozone standard unless upwind states act to reduce their emissions. Thus, under the DOER proposal, Massachusetts could have the worst of both worlds: increased costs for Massachusetts consumers without improved air quality.

Choice: New England includes a proposal that would reduce emissions from NEP's generation beyond the requirements of the environmental laws in a way that would keep NEP one

step ahead of emission reductions in upwind states. Our proposal would result in cleaner air at a reasonable cost. However, the *Choice: New England* reductions and timetable may not be appropriate for all other utilities. The Department, therefore, should not issue a generic rule or recommendation on air emission reductions on May 1.

B. The Department Does Not Have to and Should Not Address Some Other Issues Now.

1. Horizontal Market Power. The issue of horizontal market power lies beyond the Department's expertise and legal authority. Even if the Department could influence the concentration of market power on choice day, generation companies would, starting the next day, buy or sell resources within and without Massachusetts in transactions beyond the Department's jurisdiction. Other legal authorities, such as the Attorney General and the U.S. Department of Justice, have the authority to review such transactions under the antitrust laws. Moreover, those authorities will have ongoing jurisdiction. As a result, the Department need not and should not issue rules or recommendations now on horizontal market power that could slow or complicate industry restructuring.

2. Transmission. Transmission rules and tariffs are and will be addressed by the FERC. The Department, therefore, need not and should not issue any rules or recommendations with respect to transmission.

3. Performance-Based Ratemaking. The Department does not have to address performance-based ratemaking ("PBR") in order to proceed with industry restructuring. Moreover, industry restructuring proceedings should not be used to delay or prevent necessary rate filings. If and when the Department does address PBR, however, it should reset distribution rates for each company based on a current cost of service. Ironically, the electric company with the highest overall rates to customers in Massachusetts has also been the most profitable

company in recent years, while Mass. Electric, which has the lowest rates of any of the investor-owned utilities, has earned a significantly lower return. If the Department were to use current rates as a starting point for PBR, those with the highest rates would be rewarded with relatively high per customer revenues, while those with lower rates would be penalized with relatively low per customer revenues. That result would not only be unfair, it would make no sense.

The Department should readjust distribution rates before beginning PBR.

IV. Conclusion

The Department should make clear findings on the four issues on which restructuring plans differ, that are ripe for resolution, that require uniform statewide implementation and that the Department needs to address to narrow and advance restructuring: the January 1, 1998 start date, market structure, default service and functional unbundling. In the interest of facilitating restructuring, however, the Department should refrain from issuing rules or recommendations on the calculation of stranded costs and reductions in air emissions.

Respectfully submitted,

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